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TAGS: ECON EINV HR
SUBJECT: CROATIA FOREIGN DEBT WORRIES CENTRAL BANK,
BUT OTHERS UNCONCERNED

SENSITIVE BUT UNCLASSIFIED; PLEASE HANDLE
ACCORDINGLY.

¶1. (SBU) Summary: Croatia's foreign debt as a percentage of GDP reached 82.4 percent at the end of 2005 and has continued to climb in the first quarter of 2006, with some analysts predicting it could reach 86 percent of GDP by year's end. This seemingly insatiable appetite for foreign borrowing, led by Croatia's mostly foreign-owned banks, has come despite a decreased reliance on foreign credit to finance the state's budget shortfalls and draconian reserve requirements enacted by the Croatian National Bank. However, although many in Zagreb's financial community have expressed concern over such high levels of foreign debt, few believe that the country is headed for a debt crisis. Although large in its aggregate, the structure of Croatia's foreign debt is more favorable than in many countries that have experienced debt crises. With most liabilities long-term and strong foreign reserves, analysts here believe Croatia is in a relatively good position to service its debt, barring an external shock. End Summary.

Credit Boom Increases Foreign Debt

¶2. (SBU) The Croatian economy has experienced a credit boom in recent years, led by pent up demand for imported consumer goods and a mostly foreign-owned banking sector competing for market share. The banks, over ninety-three percent of which are under foreign ownership (mostly Austrian and Italian), have now replaced the state in their share of Croatia's overall foreign debt. Out of a total foreign debt of 26.2 billion euros - a stunning 82.4 percent of GDP - banks now account for 38 percent, as opposed to the state's 26.2 percent. The remaining 35.8 percent reflects private sector debt. The banking sector in Croatia has been enormously profitable in recent years, with interest rates several points over the average in the euro-zone. This has encouraged banks operating in Croatia to increase inflows of lending capital from their home offices abroad, which is then used primarily to fund consumer lending, particularly mortgages and auto loans.

Central Bank Reaction

¶3. (SBU) The Croatian National Bank has attempted with limited success so far to temper this credit boom by imposing increasingly draconian reserve requirements on bank capital from abroad. In December of 2005, the Bank raised these requirements to 55 percent after previous measures failed to slow credit growth. Damir Bronic, risk manager for Austrian Erste Bank in Zagreb told us that the current rates are likely to bring the results the Central Bank has sought, as the commercial banks cannot lend profitably with such a high reserve requirement. Bronic said the banks are now faced with a choice between lending at a loss to increase market share or attempting to attract new domestic deposits. He predicted that most would opt for the latter option, although initial figures for the first quarter of 2006 still show strong credit growth in the banking sector, so the effect of the Bank's measures are yet to be seen. Many Croatian economists are concerned that so much lending is directed at consumption, rather than business investment. However, measures that increase the cost of money will also increase the cost of investment and could have negative consequences for employment and overall economic growth.

Debt High But Manageable

¶4. (SBU) Apart from some academics, few in Zagreb's financial community appear overly concerned about Croatia's ability to service its debt. They point to several reasons for this. First is the fact that the structure of Croatia's debt is generally favorable. Most of the debt is long-term, avoiding a sudden balloon repayment scenario that would leave

lenders running for the exits. Furthermore, since the banks are borrowing from their home offices, they have wide latitude to restructure debt. Second is the fact that Croatia has relatively high levels of foreign reserves, driven both by tourism and foreign investment. Croatia's foreign reserves are over 6.5 billion euros, the equivalent of approximately 5 months of imports. Finally, Croatia's banking sector, although foreign owned, is operating in Croatia, making it unlikely that the parent banks would jeopardize their operations in the country.

Kuna Strong Despite Debt

¶5. (SBU) One of the peculiarities of Croatia's circumstances is the fact that the national currency, the kuna, has had a tendency to appreciate despite the high levels of debt and a ballooning trade deficit. IMF Zagreb Rep Athanasios Vamvakidis points out that this is partially due to the fact that Croatia's economy is so tightly linked to the economies of the euro zone. Tourism (which accounts for about 20 percent of Croatia's GDP), investment and the increasing inflow of pre-accession funds from the European Union all put upward pressure on the kuna. So far, the Central Bank has so far been able to keep a stable exchange rate against the euro through periodic market intervention. Maintenance of the exchange rate is critical for Croatia, as the vast majority of consumer debt is linked to the exchange rate, so that any significant fall in the value of the kuna could have catastrophic consequences for debtors whose income is in kunas. The relatively high value of the kuna, however, has also been a curse for the Croatian economy, as it has fueled demand for imports and is a factor in

making many Croatian exports relatively
uncompetitive.

External Crisis Wild Card

¶6. (SBU) That Croatia's foreign debt and indeed its economic growth are sustainable in the near term is generally accepted in the financial community here. However, there are a number of external wildcards that could have significant consequences for Croatia. Velimir Sonje, an economic analyst who consults for Erste Bank told us that sustained high oil prices could worsen Croatia's economic picture and the government's fiscal balance. The GOC, in an effort to soften the impact of rising gas prices on Croatian motorists and businesses is now considering reductions in the excise tax on fuel to head off even sharper price increases. While welcome for motorists, this loss of revenue could make it more difficult for the government to meet deficit targets and force the state to resort to borrowing to cover these gaps. Perhaps more worrisome, however, is the prospect of sharp rises in interest rates in the euro zone. If high energy prices trigger inflation in the euro zone and lead the ECB to raise rates sharply, these rate hikes would have a direct impact on Croatia, not only by increasing the price of new borrowing, but also by increasing the cost of some debt service. The result of this could be a contraction in credit on the domestic market that not only would dampen business investment, but would also dampen consumer spending, which has been one of the main drivers of Croatia's GDP growth in the last several years.

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